Before the
Federal Communications Commission
Washington, D.C. 20554

In the matter of	)	
	)	
1993 Annual Access Tariff Filings	)	CC Docket No. 93-193
	)	
1994 Annual Access Tariff Filings	)	CC Docket No. 94-65
	)	
	)	

ORDER

Adopted: June 28, 2004 **Released: July 30, 2004**

Response Due Date: August 30, 2004
Reply Comment Due Date: September 13, 2004

By the Commission: Commissioner Martin approving in part, dissenting in part, and issuing a statement at a later date. Commissioner Abernathy not participating.

I. INTRODUCTION

1. In this order, pursuant to section 204 of the Communications Act of 1934, as amended (Act),[1] we find just and reasonable the 1993 interstate access tariffs of price cap local exchange carriers (LECs) that implemented a sharing or lower formula adjustment in their 1992 Price Cap Indices (PCIs) and that applied add-back in computing their 1992 earnings and rates of return and resulting 1993 PCIs.[2] We find unjust and unreasonable the 1993 annual access tariffs of price cap LECs that implemented a sharing or lower formula adjustment in their 1992 PCIs and that failed to apply add-back in computing their 1992 earnings and rates of return and resulting 1993 PCIs. We make the same findings for the 1994 interstate access tariffs of price cap LECs that implemented a sharing or lower formula adjustment in their 1993 PCIs. Finally, we direct price cap LECs that implemented a sharing or lower formula adjustment and failed to apply add-back in computing their 1992 and 1993 earnings and rates of return to make certain recalculations and submissions to implement this order.

II. BACKGROUND

2. Prior to September 1990, LEC interstate access rates were subject to rate-of-return regulation. Under rate-of-return regulation, LECs could charge rates that earned a maximum allowable

[1] 47 U.S.C. § 204.

[2] Add-back requires price cap LECs, in calculating their current year interstate rates of return, to add back or subtract from their current year earnings the amount of any revenue returned to customers due to a sharing obligation or gained due to a lower formula adjustment. This rate-of-return computation determines whether the LEC must make a sharing or lower formula adjustment to its PCI for the next tariff year. Add-back eliminates the effects on the current year's earnings of sharing or low-end adjustments that were required by the prior tariff year's earnings. A "tariff year" as used here refers to the one-year period from July 1 to June 30 because interstate access tariffs are filed annually on this schedule. Thus, the 1993 interstate access tariff year runs from July 1, 1993, to June 30, 1994, and the 1993 interstate access rates are the rates in effect during this period.

return on interstate investment.[3] LECs treated any Commission-ordered refunds of excess earnings as an adjustment to earnings in the period in which the excess earnings occurred, rather than to the period in which the refund was actually paid by a reduction in rates.[4] Thus, LECs "added-back" the amount of any refund for prior excess earnings into the total earnings used to compute the rate of return for the current earnings period. A refund thus had the same effect on earnings that it would have had if a LEC had written a check for the amount of its excess earnings on the last day of the prior earnings period during which the excess earnings occurred.[5]

3. In September 1990, the Commission replaced rate-of-return regulation for the largest LECs with an incentive-based system of price cap regulation.[6] Under the original price cap plan, the ceiling or maximum price a LEC could charge for interstate access services was determined by the PCI, a formula which was adjusted annually by a measure of inflation minus a productivity factor, or "X factor."[7] A LEC's interstate rate of return in one year could be the basis for "back stop" adjustments to that carrier's price cap indices and rates in the following year.[8] Specifically, the Commission required price cap LECs to "share" a portion of their earnings above a certain level with their interstate access

[3] The maximum allowable rate of return consists of the prescribed rate of return plus four tenths of one percent of the prescribed rate of return. *See* 47 C.F.R. § 65.700.

[4] The Commission adopted a rule that required a LEC earning more than the maximum allowable rate of return on a specified segment of its operations during a two-year period automatically to refund the excess earnings directly to its interstate access customers. *Authorized Rates of Return for the Interstate Service of AT&T Communications and Exchange Carriers,* FCC 85-527 (released Sept. 30, 1985), 50 Fed. Reg. 41,350 (Oct. 10, 1985), *recon. granted in part*, FCC 86-114 (released March 24, 1986), *summarized in,* 51 Fed. Reg. 11,033 (April 1, 1986), *further recon. denied,* 2 FCC Rcd 190 (1987), *rev'd in part, American Telephone & Telegraph Co. v. FCC,* 836 F.2d 1386 (D.C. Cir. 1988)(*AT&T*). The Court of Appeals for the District of Columbia Circuit invalidated and remanded this rule because, based on its understanding that the rate of return prescribed in 1985 was both a maximum and a minimum, it reasoned that the absence of a corresponding mechanism for recovery or offset of under earnings could result in repeated under earnings that, over time, could put a LEC out of business. *AT&T,* 836 F.2d at 1389, 1393. In a separate rulemaking, the Commission adopted a mechanism and Form 492 to account for excess earnings that incorporated an add-back requirement. *Amendment of Part 65, Interstate Rate of Return Prescription: Procedures and Methodologies to Establish Reporting Requirements*, CC Docket No. 86-127, Report and Order, 1 FCC Rcd 952, 956-57, para. 43 and Appendix C (1986) (establishing a rate of return monitoring report, which includes a line to record the amount of the refund). *See also Price Cap Regulation of Local Exchange Carriers, Rate of Return Sharing and Lower Formula Adjustment*, CC Docket No. 93-179, Notice of Proposed Rulemaking, 8 FCC Rcd 4415 (1993) (*Add-Back Notice*); *Price Cap Regulation of Local Exchange Carriers, Rate of Return Sharing and Lower Formula Adjustment*, CC Docket No. 93-179, Report and Order, 10 FCC Rcd 5656 (1995) (*Add-Back Order*). Although the *AT&T* court invalidated the automatic refund rule, it left the add-back mechanism and form 492 untouched. Moreover, the court in *AT&T* expressly recognized that the Commission had authority both to prescribe a rate of return and to order refunds of excess earnings through a reduction in future rates. 836 F.2d at 1392, *citing New England Tel. and Tel. Co. v. FCC*, 826 F.2d 1101 (D.C. Cir. 1987), *cert. denied,* 490 U.S. 1039 (1989). *See also MCI Telecommunications Co. v. FCC*, 59 F.3d 1407 (1995)(Court upheld awards of damages to customers that paid rates that produced earnings in excess of prescribed maximum rates of return.).

[5] *Add-Back Order*, 10 FCC Rcd at 5656-57, para. 2.

[6] *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786 (1990) (*LEC Price Cap Order*). At that time the largest LECs included the seven regional Bell Operating Companies (BOCs). As a result of mergers and acquisitions, today there are four BOCs. For a complete summary of the original price cap plan, *see LEC Price Cap Order*, 5 FCC Rcd at 6787-89, paras. 5-19.

[7] *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, Fourth Report and Order, *Access Charge Reform*, CC Docket No. 96-262, Second Report and Order, 12 FCC Rcd 16642, 16646, para. 3 (1997) (*Price Cap Fourth Report and Order*). *See also LEC Price Cap Order*, 5 FCC Rcd at 6792, paras. 47-49. Exogenous costs also are added in determining the PCI. *See* 47 C.F.R. § 61.45(a).

[8] *LEC Price Cap Order*, 5 FCC Rcd at 6790-91, paras. 21-37.

customers by lowering their PCIs and rates in the following year.[9] This mechanism is called a "sharing obligation." The Commission's rules also permitted price cap LECs earning less than 10.25 percent in a particular year to adjust their PCIs and rates upward in the following year to a level that would have allowed them to achieve an earnings rate of at least 10.25 percent for the year in which they under-earned.[10] This mechanism is called a "low-end" or "lower formula" adjustment. In devising these "back stop" adjustments, the Commission imported the concept of "rate of return" directly from the previous rate-of-return regime to ensure that LEC rates under price cap regulation did not become unreasonably high or low due to the varying operational and economic circumstances of the many individual LECs.[11] The Commission determined that the sharing and low-end adjustments would be one-time adjustments to a single year's rates, so as not to affect future earnings.[12] To provide price cap LECs greater incentives to increase efficiency, the Commission eliminated the sharing obligation in 1997.[13]

4. The first application of the sharing and low-end adjustment mechanisms occurred in the 1992 annual access tariff filings. LECs with earning levels above 12.25 percent in 1991 lowered their PCIs in tariff year 1992 because of the sharing requirement. LECs with earnings below 10.25 percent in 1991 increased their PCIs in tariff year 1992 because of the low-end adjustment mechanism. The issue of how the sharing and low-end adjustments in 1992 should be reflected in the LECs' 1992 earnings figures, which were used to determine the sharing and low-end adjustments for tariff year 1993, was raised in the 1993 annual access tariff filings. Some price cap LECs proposed using 1992 earnings levels without the add-back adjustment, while others applied an add-back adjustment. The latter approach was favored by those LECs that had received a low-end adjustment in 1992 because it allowed them to charge higher rates in 1993. The LECs that experienced higher earnings during the same period chose not to apply an add-back adjustment, which would have required greater sharing obligations on their part.[14]

5. To address the question of whether or not to apply the add-back adjustment, the Commission took two separate actions. For the 1993 annual access tariffs, the Common Carrier Bureau[15] suspended the tariffs of price cap LECs that had implemented a sharing or lower formula adjustment in 1992 for one day, issued an accounting order, and initiated an investigation.[16] Before the Commission

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[9] *Id.* at 6801, para. 124. The amount of the sharing obligation varied with certain choices made by each carrier. For example, a price cap LEC opting for an X-factor of 3.3 percent and earning a rate of return above 12.25 percent was required to share half of earnings above 12.25 percent and all earnings above 16.25 percent with its access customers. *Id*. at 6801, para. 125. For LECs that elected a more challenging 4.3 percent X factor, 50 percent sharing began for rates of return above 13.25 percent, and 100 percent sharing began at rates of return above 17.25 percent. *Id*. at 6787-88, paras. 7-10.

[10] *Id.* at 6802, para. 127. This low end adjustment has been eliminated for price cap LECs that exercise pricing flexibility. 47 C.F.R. § 69.731.

[11] *Id.* at 6801, para. 120. *See also Add-Back Notice*, 8 FCC Rcd at 4416, para. 7.

[12] *LEC Price Cap Order*, 5 FCC Rcd at 6803, para. 136. *See also Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, Order on Reconsideration, 6 FCC Rcd 2637, 2691 n.166 (1991) (*LEC Price Cap Reconsideration Order*), *aff'd sub nom*. *National Rural Telecom Ass'n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993).

[13] *See Price Cap Fourth Report and Order*, 12 FCC Rcd at 16699-70, paras. 147-48.

[14] An example demonstrating the implications of applying the add-back adjustment was included in the *Add-Back Order*, and is set out in the Appendix.

[15] In March 2002, the Commission renamed the Bureau the Wireline Competition Bureau (Bureau).

[16] *See 1993 Annual Access Tariff Filings*, CC Docket No. 93-193, *National Exchange Carrier Association Universal Service Fund and Lifeline Assistance Rates, Transmittal No. 556,* CC Docket No. 93-123, *GSF Order Compliance Filings, Bell Operating Companies' Tariff for the 800 Service Management System and 800 Data Base Access Tariffs,* CC Docket No. 93-129, Memorandum Opinion and Order Suspending Rates and Designating Issues for Investigation, 8 FCC Rcd 4960, 4965, para. 32 (Com. Car. Bur. 1993) (*1993 Designation Order*).

completed the 1993 investigation, price cap LECs filed their 1994 annual access tariffs. Because of the similarities of the add-back issues in 1993 and 1994, the Bureau suspended the 1994 access tariffs of the price cap LECs that had implemented a sharing or low-end adjustment in 1993 and incorporated the 1994 access tariffs into the 1993 investigation.[17] In doing so the Bureau stated: "prior to the termination of this [1994] investigation, we will give parties an opportunity to present any legal argument or factual circumstances that would lead us to conclude that the decisions reached in [the 1993 investigation] on add-back issues should not control our treatment of the 1994 access transmittals."[18] Separately, the Commission initiated a rulemaking to consider whether add-back should be required as an explicit rule.[19] In 1995, the Commission determined in the *Add-Back Order* that add-back produced the same results for price cap and rate-of-return regulation, was consistent with price cap efficiency incentives and was necessary to enforce earnings restrictions, and, therefore, was a required element of price cap earnings calculations.[20] It adopted this rule prospectively for the 1995 annual access tariff filings, specifically reserving for the 1993 and 1994 tariff investigations the question of whether the price cap rules before the *Add-Back Order* required an add-back adjustment.[21] In adopting the rule prospectively, the Commission noted that, "[W]e believe that adoption of this explicit rule – even if we were to assume that the add-back adjustment is not already required under existing rules – does not constitute a major change to the LEC price cap rules."[22] Finally, on April 7, 2003, the Commission issued a public notice seeking comment to refresh the record in this proceeding, and to present any legal arguments or factual circumstances supporting a conclusion that a determination of the add-back issue for the 1993 access tariffs should not control the treatment of add-back for the 1994 access tariffs.[23]

III. DISCUSSION

A. Positions of the Parties

6. In general, the LECs contend that prior to adoption of the *Add-Back Order* in 1995, application of an add-back adjustment was either optional[24] or not allowed.[25] SBC and Verizon contend that, while add-back was not required, it was reasonable for price-cap carriers to apply or not apply add-back in calculating their 1993 sharing obligations.[26] SBC also argues that it would only be reasonable to require add-back if the sharing mechanism was intended to act as a refund and that the purpose of sharing

[17] *See 1994 Annual Access Tariff Filings*, CC Docket No. 94-65, *National Exchange Carrier Association Universal Service Fund and Lifeline Assistance Rates, Transmittal No. 612,* Memorandum Opinion and Order Suspending Rates, 9 FCC Rcd 3705, 3713, para. 12 (Com. Car. Bur. 1994) (*1994 Suspension Order*).

[18] *Id.*

[19] *Add-Back Notice*, 8 FCC Rcd at 4415.

[20] *Add-Back Order*, 10 FCC Rcd at 5659-64, paras. 17-45.

[21] *Add-Back Order*, 10 FCC Rcd at 5657, n.3.

[22] *Id.* at 5565, para. 50.

[23] *Further Comment Requested on the Appropriate Treatment of Sharing and Low-End Adjustments Made by Price Cap Local Exchange Carriers in Filing 1993 and 1994 Interstate Access Tariffs*, *1993 Annual Access Tariffs*, CC Docket No. 93-193, *1994 Annual Access Tariffs,* CC Docket No. 94-65, Public Notice, 18 FCC Rcd 6483 (2003) (*Add-Back Public Notice*).

[24] *1993 Annual Access Tariffs*, CC Docket No. 93-193; *1994 Annual Access Tariffs,* CC Docket No. 94-65, Comments of BellSouth at 12, filed May 5, 2003 (*BellSouth Comments*); Comments of SBC Communications, Inc. at 5-8, filed May 5, 2003 (*SBC Comments*); Comments of Verizon at 12-14, filed May 5, 2003 (*Verizon Comments*); Reply Comments of Verizon at 6-9, filed May 19, 2003 (*Verizon Reply*).

[25] *1993 Annual Access Tariffs*, CC Docket No. 93-193; *1994 Annual Access Tariffs*, CC Docket No. 94-65, Reply Comments of Sprint Corporation at 2, filed May 19, 2003 (*Sprint Reply*).

[26] *SBC Comments* at 5-8; *Verizon Comments* at 7-12.

was to better calibrate the PCI to actual productivity gains.[27] Sprint argues that add-back was not allowed at all, and points out that at least one of its subsidiary LECs did not apply an add-back adjustment in calculating its earnings even though it was eligible for a low-end adjustment.[28] Qwest and Sprint contend that the outcome of these investigations is dictated by the outcome of the add-back rulemaking.[29] Thus, Qwest argues and Sprint agrees that, because the Commission concluded in the *Add-Back Order* that the rule change requiring an add-back adjustment would be effective prospectively, the only remaining issue before the Commission is the administrative closing of these investigations.[30]

7. All of the LECs assert that any finding imposing an add-back requirement under these tariff investigations would amount to impermissible retroactive rulemaking.[31] Verizon further asserts that requiring an add-back requirement now would have an unjust retroactive impact because prior knowledge of the existence of a required add-back adjustment would have influenced a carrier's selection between a 3.3 percent or 4.3 percent productivity factor or X-factor, which in turn would have affected revenue.[32] BellSouth asserts that the Commission could not have intended to require an add-back adjustment in 1993 and 1994 because neither the price cap rules nor the annual reporting form in effect at that time contained provisions addressing treatment of sharing or low-end adjustments from prior years.[33] All of the LECs further argue that, by taking more than twelve months to conclude these investigations, the Commission is barred from ordering refunds or taking any further action.[34] The LECs assert, therefore, that the Commission should either terminate the investigations with no further action,[35] or find that the application of add-back was at the option of each LEC.[36]

8. AT&T contends that the 1993 and 1994 access tariffs of LECs that failed to compute their rates of return by applying the add-back adjustment are unlawful because, by the Commission's own analysis, the intended purposes of price cap regulation could only be achieved by applying add-back.[37] AT&T also argues that it would be arbitrary to allow LECs to apply add-back on an optional basis because the rates established by LECs that opted not to apply add-back would frustrate the intended

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[27] *1993 Annual Access Tariffs*, CC Docket No. 93-193; *1994 Annual Access Tariffs*, CC Docket No. 94-65, Letter from David Cartwright, Director, Federal Regulatory, SBC, to Marlene H. Dortch, Secretary, Federal Communications Commission at 8-9 (filed Feb. 27, 2004) (*SBC February 27 ex parte*).

[28] *Sprint Reply* at 2.

[29] *1993 Annual Access Tariffs*, CC Docket No. 93-193; *1994 Annual Access Tariffs,* CC Docket No. 94-65, Comments of Qwest Corporation at 2-6, filed May 5, 2003 (*Qwest Comments*); *Sprint Reply* at 2.

[30] *Qwest Comments* at 2-6; *Sprint Reply* at 2.

[31] *BellSouth Comments* at 8-12; *Qwest Comments* at 3-9; *SBC Comments* at 8-10; *Verizon Comments* at 11-12; *1993 Annual Access Tariffs*, CC Docket No. 93-193; *1994 Annual Access Tariffs,* CC Docket No. 94-65, Reply Comments at 4-6, filed May 19, 2003 (*BellSouth Reply)*; Reply Comments of SBC Communications at 3-5, filed May 19, 2003 (*SBC Reply*); *Sprint Reply* at 4.

[32] *Verizon Comments* at 14; *Verizon Reply* at 4.

[33] *BellSouth Comments* at 8-10. Sprint makes the same observation in support of its argument that add-back was prohibited during the years in question. *See Sprint Reply* at 2.

[34] *BellSouth Comments* at 2-7; *Qwest Comments* at 7, n.19; *SBC Comments* at 4; *Verizon Comments* at 14-18; *Sprint Reply* at 1-3.

[35] *BellSouth Comments* at 12; *Qwest Comments* at 9; *Verizon Comments* at 14-18; *BellSouth Reply* at 4-6.

[36] *SBC Comments* at 10; *SBC Reply* at 6*; Sprint Reply* at 4.

[37] *1993 Annual Access Tariffs*, CC Docket No. 93-193; *1994 Annual Access Tariffs,* CC Docket No. 94-65, Comments of AT&T Corp. at 14-16, filed May 5, 2003 (*AT&T Comments*); Reply Comments of AT&T Corp. at 4-7, filed May 19, 2003 (*AT&T Reply*).

purposes of price cap regulation.[38] AT&T estimates that a decision requiring add-back would result in a $55 million refund to access customers. AT&T estimates that if the Commission determines that add-back should not have been applied, those LECs that did apply add-back would be required to refund $37.5 million.[39] In reply to LEC claims that requiring add-back now would amount to impermissible retroactive rulemaking, AT&T argues that a tariff investigation is a stand-alone rulemaking in which the Commission may lawfully make appropriate, rate-related determinations.[40] In reply to claims that the Commission is barred by the 1988 amendments to the Act setting a twelve-month period for concluding a tariff investigation, AT&T contends that neither court opinions nor the legislative history of the twelve-month provision support such an interpretation.[41]

B. Failure to Apply Add-Back Results in Unreasonable Rates.

9. The central issue before us is whether just and reasonable rates can be achieved pursuant to the requirements of section 201 of the Act and the *LEC Price Cap Order* if add-back is not required.[42] As discussed earlier,[43] the term "add-back" describes the process that eliminates the effects on the current year's earnings of sharing or low-end adjustments that were required by the prior year's earnings. The process requires a price cap LEC to add an amount equal to the sharing adjustment to its current year's revenues before calculating its rate of return for the current year. If the LEC made a low-end adjustment in the current year's rates to reflect low earnings in the prior year, the amount of the adjustment will be subtracted from the current year's revenues before computing the rate of return for the current year. The current year's earnings, thus adjusted, will determine whether a sharing or low-end adjustment for the current year is warranted in the next tariff year.[44]

10. In general, for purposes of determining any adjustment in the next tariff year, adding an amount equal to the sharing adjustment to the current year's earnings calculation increases a LEC's earnings to the level that they would have reached if there had been no sharing adjustment.[45] Similarly, by excluding low-end adjustment amounts from the current year's earnings calculation, the LEC's earnings level used to compute the next tariff year's sharing or low-end adjustments would be lowered to the level that earnings would have reached if there had been no low-end adjustment.[46] This result is entirely consistent with the intent of the *LEC Price Cap Order*.

11. The intent of the *LEC Price Cap Order* was to enhance efficiency on the part of the LECs by establishing profit-making incentives while placing reasonable parameters on carrier earnings.[47] The Commission was careful to base X-factor calculations (adjustments to the PCI) on industry-wide productivity, not on the rates of return for individual LECs.[48] In contrast, the Commission intended the sharing and low-end adjustment mechanisms, as part of the backstop plan, to effect hard upper limits on

[38] *AT&T Comments* at 15-16; *AT&T Reply* at 7-11.

[39] *AT&T Comments* at 18-19.

[40] *AT&T Comments* at 15; *AT&T Reply* at 1-6.

[41] *AT&T Reply* at 11-12. *See also* P.L. 100-594, § 8(b), 102 Stat. 3028 (1988).

[42] 47 U.S.C. §§ 201, 204; *LEC Price Cap Order*, 5 FCC Rcd at 6801-6807, paras. 125-160.

[43] *See* n.2, *supra.*

[44] *See* Appendix at 2, 4.

[45] *Id.* at 2.

[46] *Id.* at 4.

[47] *LEC Price Cap Order*, 5 FCC Rcd at 6787, para. 1.

[48] *Id.* at 6796-98, paras. 75-95.

LEC earnings and create an earnings floor.[49] They were based on individual LEC rates of return and were intended to operate as a one-time adjustment to a single year's rates, so a LEC would not risk affecting future earnings.[50] The Commission, in fact, explicitly declined to adopt a proposed stabilizer mechanism that would have permanently adjusted individual LEC PCIs to reflect individual productivity gains.[51] Rather, the Commission chose a sharing mechanism that was intended only to return excess earnings, plus interest, to customers through a one-time reduction in a carrier's PCI.[52] Similarly, the Commission chose to allow adjustments for low earnings that would ensure LECs could continue to earn at the minimum level required to "raise the capital necessary to provide new services that [their] local customers expected."[53] Applying add-back ensures the results the Commission intended in adopting the sharing and lower-formula adjustment mechanisms.

12. If add-back is not applied to sharing, future earnings are distorted because reductions that were intended to return excess earnings to customers are treated as actual reductions in carrier productivity.[54] Likewise, if add-back is not applied to low-end adjustments, future earnings are distorted because increases that were intended to allow the LEC the opportunity to make-up for earnings below the rate floor are treated as actual increases in productivity.[55] Consequently, the result of not applying add-back to LECs subject to sharing obligations is that such carriers may earn above the earnings ceilings that the Commission adopted in the *LEC Price Cap Order*.[56] Similarly, without add-back, LECs that qualify for a low-end adjustment may not obtain the full opportunity to earn the minimum level adopted in the *LEC Price Cap Order*.[57] Because the result of not applying add-back defeats the purpose of the earnings parameters adopted in the *LEC Price Cap Order,* we find it unreasonable for the LECs subject to this investigation to not apply add-back.

13. We also reject SBC's contention that the sharing mechanism was not a refund but a means of calibrating the PCI to actual LEC productivity gains on a going forward basis, and thus add-back was not required.[58] As noted above, the Commission considered adopting a stabilizer based on individual LEC earnings as a permanent adjustment to calibrate individual LEC PCIs.[59] The Commission

[49] *Id.* at 6801, 6804, paras. 123-25, 147-48. For example, a carrier choosing a 3.3 percent productivity offset would be allowed "to reach a maximum 14.25 percent rate of return." *Id.*

[50] *Id.* at 6803, para. 136. *See also Add-Back Order,* 10 FCC Rcd at 5659, para. 17 and n.27.

[51] *LEC Price Cap Order*, 5 FCC Rcd at 6803, paras. 134-36.

[52] *Id.* at 6801, paras. 124-25.

[53] *Id.* at 6804, para. 148.

[54] *See* Appendix at 2-3.

[55] *Id.* at 3-5.

[56] *Id.* at 2-3.

[57] *Id.* at 3-5.

[58] *SBC February 27 ex parte* at 8-9.

[59] *LEC Price Cap Order,* 5 FCC Rcd at 6803, paras. 134-35. The Commission proposed the adoption of a stabilizer as a backstop mechanism to protect against LEC excess or under earnings under price caps in the *Price Cap Second FNPRM*. *Policy and Rules Concerning Rates for Dominant Carriers*, Report and Order and Second Further Notice of Proposed Rulemaking, CC Docket No. 87-313, 4 FCC Rcd 2873, 3212-19 (1989) (*Price Cap Second FNPRM*). The proposed stabilizer would have permanently modified a LEC's PCI if the LEC's earnings fell outside a reasonable range, which was identified as the authorized return, plus or minus 2 percent. *Id*. at 3215, para. 708. In contrast to the sharing and low-end adjustment backstop mechanisms that were adopted, the stabilizer was a prospective mechanism that would have eliminated any obligation to refund excess earnings to end users or opportunity to recoup earnings shortfalls. *Id*. at 3215-16, para. 708. The Commission rejected the proposed stabilizer in the *LEC Price Cap Order*. *LEC Price Cap Order*, 5 FCC Rcd at 6802-03, paras. 127, 135.

explicitly rejected this stabilizer in response to LEC concerns about its potential adverse effect on productivity incentives.[60] For example, if the Commission had adopted a stabilizer, a LEC with an unusually productive year could limit its future profits.[61] The Commission's discussion of the refund option for excess earnings is instructive.[62] It is true that the Commission rejected proposals for a direct refund requirement when it adopted the sharing and low-end adjustment backstop mechanisms. The Commission, however, was addressing concerns about the mechanics of returning excess earnings to customers, not concluding that the sharing mechanism would be used to calibrate individual LEC PCIs.[63] The Commission rejected direct refunds due to administrative difficulties related to the allocation of refunds among customers, not because refunds were contrary to the intent of the sharing mechanism.[64] For example, the Commission rejected Bell Atlantic's proposal to give direct refunds to carrier customers and reflect the balance in an adjustment to the PCI because such refunds could have provided a "double refund [to carrier customers] at the expense of end users."[65] Accordingly, nothing in SBC's contention persuades us that add-back should not be required for the 1993 access tariffs.

14. We also note that rate of return, as a component of the backstop, is not redefined in the *LEC Price Cap Order*. Instead, it was incorporated as a widely familiar device from the previous rate-of-return system that would be used to determine sharing and low-end adjustments.[66] The price cap methodology, particularly during the years in which sharing was applied, was closely linked to rate-of-return regulation. Price cap carriers reported their earnings and made sharing or low-end adjustments when they met certain specific benchmark earnings levels. Add-back was applied under rate-of-return regulation "to provide a clear picture of current earnings for the reporting period" and to see "whether an access category being adjusted through a refund is earning above its adjusted maximum rate of return . . . ."[67] As with rate-of-return carriers, price cap LECs' current tariff year earnings become reasonably accurate only when they add-back the prior year's sharing or low-end adjustment amounts. Accordingly, requiring add-back is consistent with prior Commission ratemaking practices.

15. After reviewing the relevant orders and comments, and considering the different rates of return when add-back is applied and add-back is not applied, we conclude that an add-back requirement is essential if the sharing and low-end adjustment mechanisms are to achieve their intended purposes. We find that just and reasonable rates cannot be achieved without the application of add-back because of the distortions that result when it is not applied. Add-back corrects deviations in earning calculations, and ensures that a LEC's earnings fall within the earnings parameters that the Commission selected in the *LEC Price Cap Order*.

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[60] The Commission rejected the automatic stabilizer because its adjustment to the PCI would have had a larger and more prolonged effect on earnings, rather than the one-time effect of the sharing mechanism. *LEC Price Cap Order*, 5 FCC Rcd at 6803, para. 136.

[61] *Id*.

[62] *Id.* at 6805, paras. 152-54.

[63] *Id.* at 6801, 6805, paras. 124-25, 151-54. **"**This level of sharing will ensure that consumers receive their fair share of productivity gains that occur, just as they would in an industry with keener competition. The customer share plus interest will be returned in the form of a one-time reduction in the PCI for the next rate period . . . ." *Id.* at 6801, para. 124.

[64] *Id.* at 6805, para. 153.

[65] *Id.* at 6805, para. 154.

[66] *Id.* at 6801, paras. 120-121. *See also Add-Back Order,* 10 FCC Rcd at 5657, para. 7.

[67] *Amendment of Part 65, Interstate Rate of Return Prescription: Procedures and Methodologies to Establish Reporting Requirements*, CC Docket No. 86-127, Report and Order, 1 FCC Rcd 952, 956-57, para. 43.

C. Requiring a Rate Adjustment Pursuant to a Section 204 Tariff Investigation Is Not Retroactive Rulemaking.

16. Commenters' claims that the Commission is precluded from requiring add-back in this tariff investigation require us to determine which rules, if any, apply here.[68] It is well established that an administrative agency in the performance of its statutory duties must adhere to its regulations.[69] Therefore, if the regulations in effect when the tariffs were filed had established the regulatory treatment of add-back, we would be required to follow those rules in determining the lawfulness of the tariffs under investigation. We find, however, that our price cap regulations did not explicitly address add-back until 1995. Moreover, in adopting these amendments we determined that they would be given prospective application only.[70] We find, therefore, that the applicable rules, *i.e.*, the pre-1995 rules in effect when the tariffs under investigation were filed, did not speak explicitly to the add-back practices at issue in this investigation. Because we do not apply the 1995 rule amendments in determining the lawfulness of the tariffs under investigation, there can be no reasonable argument based on those amendments for alleging that the Commission in this investigation engages in impermissible retroactive rulemaking.

17. According to the LECs, the fact that the Commission's pre-1995 rules neither required nor prohibited application of add-back precludes the Commission from determining the reasonableness of the LECs' add-back practices in the tariffs under investigation. We disagree. Section 204(a) explicitly authorizes the Commission to investigate the lawfulness of "any new or revised charge, classification, regulation or practice" contained in a filed tariff.[71] This broad grant of authority empowers the Commission to determine the reasonableness of applying add-back in the tariffs under investigation whether or not the Commission at the time the tariffs were filed had promulgated rules explicitly requiring add-back.[72] A tariff investigation is a rulemaking of particular applicability under the Administrative Procedure Act[73] and the Commission, in the exercise of its section 204 authority, "routinely makes significant policy and methodological decisions based on the records developed in tariff investigations."[74] The Commission has also explained why it may order refunds at the completion of an investigation:

> as a tradeoff for permitting rates under investigation to go into effect, Section 204(a) specifically authorizes the Commission to order refunds at the conclusion of such a proceeding if such relief is appropriate. Thus, it is obvious from the

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[68] *See, e.g., BellSouth Comments* at 8-12; *Qwest Comments* at 3-9; *SBC Comments* at 8-10; *Verizon Comments* at 11-12; *Sprint Reply* at 2.

[69] *See,* e.g., *Adams Telecom, Inc. v. FCC,* 38 F.3d 576, 581 (D.C. Cir. 1994), *quoting Reuters Ltd. v. FCC*, 781 F.2d 946, 950 (D.C.Cir.1986) ("[I]t is elementary that an agency must adhere to its own rules and regulations."). *See Steenholdt v. FAA,* 314 F.3d 633, 638 (D.C. Cir. 2003); *Southwestern Bell Tele. Co. v. FCC,* 28 F.3d at 169.

[70] *Add Back Order,* 10 FCC Rcd at 5665, para. 49.

[71] 47 U.S.C. § 204(a). Complementing the Commission's section 204 authority, section 4(i) authorizes the agency to "perform any and all acts, make such rules and regulations, and issue such orders, not inconsistent [with the express provisions of the Act], as may be necessary in the execution of its functions." 47 U.S.C. § 154(i). The "wide-ranging source of authority" in this "necessary and proper clause" empowers the Commission to take "appropriate and reasonable" actions in furtherance of its regulatory duties. *New England Tele. & Tele. Co. v. FCC,* 826 F.2d 1101, 1108 (D.C. Cir. 1987), *cert. denied,* 490 U.S. 1039 (1989).

[72] *Cf. In re Permian Basin Rate Cases,* 390 U.S. 747, 1365 (1968) (Supreme Court, in analyzing agency's power under cognate ratemaking provisions of the Federal Power Act, held that "the Commission's broad responsibilities . . . demand a generous construction of its statutory authority.").

[73] 5 U.S.C. § 551(4).

[74] *Tariffs Implementing Access Charge Reform,* CC Docket No. 97-250, Memorandum Opinion and Order, 13 FCC Rcd 14683, 14717, para. 80 (1998). *See generally Permian Basin Rate Cases,* 390 U.S. at 747.

> nature of the statutory scheme, and from the fact that this proceeding was commenced through a Designation Order rather than a Notice of Proposed Rule Making, that any conclusions this Commission reached with respect to the lawfulness of strategic pricing would be applied to rates that took effect subject to the investigation, and that the Commission would exercise its statutory authority to determine whether a refund was appropriate.[75]

Moreover, section 204(a) assigns to the carriers the burden of proving the lawfulness of the filed tariffs under investigation.[76] The LECs do not satisfy that statutorily imposed burden merely by showing that they have not violated explicit regulatory provisions. To the contrary, the LECs must affirmatively show that their tariffed "charges, practices, classifications, and regulations" are "just and reasonable" under the Act.[77]

18. Commenters' assertions to the contrary, nothing in the *Add-Back Order* supports a claim that applying add-back to the 1993 and 1994 access tariffs constitutes impermissible retroactive rulemaking. The *LEC Price Cap Order's* silence on add-back was not a basis to conclude that the Commission could not determine, in the course of these section 204 investigations, that the LECs' tariffs that did not incorporate add-back produced rates that were unjust and unreasonable within the meaning of section 201(b). In adopting add-back prospectively for the 1995 access tariffs, the Commission reserved for the tariff investigations the question of whether the price cap rules before the *Add-Back Order* required an add-back adjustment.[78] Thus, the *Add-Back Order* did not, as Qwest and Sprint claim,[79] dictate the result of the tariff investigations.

19. Similarly, nothing in the court opinion upholding the add-back amendments, *Bell Atlantic v. FCC,* supports a claim that requiring add-back in this investigation would result in an impermissible retroactive rule.[80] While the court found that the Commission properly applied the 1995 add-back rule prospectively, it expressly noted the ongoing tariff investigations with no indication that its finding applied to those separate, ongoing proceedings.[81] In responding to LEC claims that even a prospective add-back rule was unlawfully retroactive because it changed past legal consequences of their choice between a 3.3 percent or 4.3 percent X factor, the Court noted that the LECs "made their X-factor decisions in the face of considerable uncertainty about whether the 1990 *LEC Price Cap Order* included add-back . . . Petitioners who chose the 3.3 percent offset in previous years have already received the benefit of that decision through higher price caps in those years."[82] This language cannot be construed as a finding that the *Add-Back Order* precludes requiring add-back in the tariff investigations. Rather, the court noted that the Commission concluded in the *Add-Back Order* that add-back had been implicit in the

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[75] *Investigation of Special Access Tariffs of Local Exchange Carriers*, CC Docket No. 85-166, Phase II, Part 1, Memorandum Opinion and Order, 5 FCC Rcd 4861, para. 7 (1990).

[76] 47 U.S.C. § 204(a).

[77] 47 U.S.C. § 201(b) ("[A]ny . . . charge, practice, classification, or regulation that is unjust or unreasonable is hereby declared to be unlawful.")

[78] *Add-Back Order*, 10 FCC Rcd at 5657, n.3 ("We do not decide in this rulemaking whether an add-back adjustment is required for purposes of the 1993 and 1994 Annual Access Tariff Filings. That issue is under examination as part of our investigation of the 1993 and 1994 Annual Access Tariff Filings [citations omitted].").

[79] *Qwest Comments* at 2-6; *Sprint Reply* at 2.

[80] *Bell Atlantic Tele. Cos. v. FCC*, 79 F.3d 1195, 1206-07 (D.C. Cir. 1996) (*Bell Atlantic*).

[81] *Id.* at 1201, 1203.

[82] *Id.* at 1207.

original price cap rules.[83]

20. This history also defeats LEC claims that it would now be inequitable for the Commission to find the 1993 access rates of LECs failing to apply add-back in determining their 1993 sharing or lower formula adjustment obligations to be unreasonable and to order refunds. Specifically, Verizon claims that, had the LECs known that the Commission would require add-back for the 1993 and 1994 access tariffs, they might have made a different selection between the 3.3 percent and 4.3 percent X factors.[84] The *Bell Atlantic* court's finding that the LECs had already received the benefit of their productivity factor choices applies equally to the 1993 and 1994 access tariffs. Further, the LECs were on notice from the time their tariffs were suspended that add-back practices were open to question and had been found to raise a substantial question of lawfulness under the Act for which the application of add-back was a potential remedy.[85] We believe it would not be fair to deny customers that have paid the allegedly unlawful charges a remedy because of the delay in concluding this proceeding. Moreover, to the extent that we find the tariffed rates to have been unlawful, requiring refunds does not amount to a penalty; it merely requires the return of revenues to which the LECs were not entitled in the first place.[86]

D. The Section 204(a)(2)(B) Twelve-Month Time Limit Does Not Preclude a Finding of Unreasonable Rates

21. We reject commenters' claims that the Commission lacks authority to pursue this tariff investigation because it did not complete the investigation within the twelve month deadline established by section 204(a)(2)(B).[87] We acknowledge that significant time has passed since the Commission initiated this investigation. Nevertheless, the Commission's failure to conclude this tariff investigation within the statutory time frame does not affect our authority to conduct it to its conclusion.

22. Section 204(a)(1) expressly authorizes the Commission to determine the lawfulness of filed tariffs.[88] While section 204(a)(2)(B) directs the Commission to make that determination within twelve months, it does not "specify a consequence for noncompliance with statutory timing provisions,"[89] let alone prescribe the "drastic remed[y]" of ousting the agency of jurisdiction.[90] The Supreme Court has made clear that the failure of a governmental entity to act within a statutory deadline does not itself divest that entity of jurisdiction to take subsequent action.[91] Consistent with that principle, the Eighth Circuit Court of Appeals, in approving a refund ordered twelve years after initiation of a tariff investigation, has

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[83] *Id.* at 1201-1202.

[84] Verizon Comments at 14.

[85] *See 1993 Designation Order*, 8 FCC Rcd at 4965, para. 33, *1994 Suspension Order*, 9 FCC Rcd at 3713, para. 12.

[86] *See New England Tele. & Tele. Co.,* 828 F.2d at 1107 (characterizing a refund requirement as a "dispassionate remedy" that requires carriers "merely to give up what they never should have collected.")

[87] *See, e.g., Verizon Comments* at 14-18; *BellSouth Comments* at 2-7; *SBC Comments* at 4. The 1996 amendments to the Act established a five month deadline for completing tariff investigations, but maintained the twelve month deadline established by the 1988 amendments to the Act for tariff investigations begun prior to the 1996 amendments. *See* P.L. 104-104, sec. 402, § 11, 110 Stat. 56, 129 (1996); 47 U.S.C. §§ 204(a)(2)(A) and (B). *See also* P.L. 100-594, § 8(b), 102 Stat. 3028 (1988).

[88] 47 U.S.C. § 204(a)(1).

[89] *Barnhart v. Peabody Coal Co.,* 537 U.S. 149, 159 (2003).

[90] *Brock v. Pierce County,* 476 U.S. 253, 260 (1986).

[91] *See, e.g., Barnhart v. Peabody Coal Co.,* 123 S. Ct. 748, 754-755 (2003); *United States v. Montalva-Murillo,* 495 U.S. 711, 717-18 (1990); *Brock v. Pierce County,* 476 U.S. 253, 260 (1986); s*ee also Regions Hosp. v. Shalala,* 522 U.S. 488, 457 (1988) ("The Secretary's failure to meet the deadline, a not uncommon occurrence when heavy loads are thrust on administrators, does not mean that official lacked power to act beyond it.").

held that "the time constraint imposed by section 204 does not operate as a statute of limitations and that its violation therefore does not end the FCC's authority to act."[92]

23. Further, *Illinois Bell Tele. Co. v. FCC*, cited by Verizon in support of its contention that the Commission may not order refunds after twelve months have passed,[93] is inapposite. In that case, the District of Columbia Circuit held that the Commission lacks authority to order a refund under section 204 unless it has first issued a suspension order.[94] The Court did not address the wholly separate issue of whether the Commission's failure to act within the section 204(a) deadline divests the agency of its authority to investigate a tariff and to order a refund. Indeed, the District of Columbia Circuit in other contexts has "repeatedly concluded that missing a statutory deadline does not divest an agency of authority over a case or issue."[95]

24. Commenters' construction of section 204(a)(2)(B) would undermine the statutory purpose. Congress enacted the time limits in section 204(a)(2)(B) in order "to spur the [Commission] to action, not to limit the scope of [its] authority."[96] A primary purpose of section 204 is "to protect consumers and competitors from unlawful rates in effect while the investigation is pending."[97] Divesting the Commission of its authority to make customers and competitors whole by ordering refunds at the conclusion of a tariff investigation would unfairly deprive innocent ratepayers of a statutory remedy because of the delay by the agency.[98] We do not believe that Congress intended that anomalous result when it enacted section 204(a)(2)(B).[99]

E. FCC Form 492A Does Not Demonstrate That Add-Back Is Not Required

25. Some commenters assert that, because the Commission changed the annual rate of return report form for price cap LECs, it intended not to require price cap LECs to apply an add-back adjustment in calculating their rates of return.[100] In April 1993, the Commission announced approval by the Office of Management and Budget (OMB) of the revised annual rate of return reporting form for price cap LECs,

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[92] *Southwestern Bell Tele. Co. v. FCC,* 138 F.3d 746, 748 (8th Cir. 1998).

[93] *Verizon Comments* at 15-16.

[94] *Illinois Bell Tele. Co. v. FCC*, 966 F.2d 1478 (D.C. Cir. 1992). Subsequently, however, the Eighth Circuit held that the Commission's authority under section 204(a) to investigate a tariff and to order refunds is not conditioned upon the issuance of a suspension order. *Southwestern Bell Tele Co. v. FCC*, 138 F.3d at 747.

[95] *Gottlieb v. Pena,* 41 F.3d 730, 733 (D. C. Cir. 1994).

[96] *Brock v. Pierce County,* 476 U.S. at 265.

[97] *See* Statement by Sen. Daniel K. Inouye, 134 Cong,. Rec. H10453 (Oct. 19, 1988), *reprinted in* 1988 U.S. Code Cong. & Admin. News at 4111, 4112 (*Inouye Statement*).

[98] *Brock v. Pierce County*, 476 U.S. at 263-64. *See also United States v. Montalva-Murillo*, 495 U.S. 718 ("[C]onstruction of the Act must conform to the "'great principle of public policy, applicable to all governments alike, which forbids that the public interests should be prejudiced by the negligence of the officers of agents to whose care they are confided.").

[99] We note that the legislative history shows that Congress contemplated that parties aggrieved by a section 204(a)(2)(B) violation would have the opportunity to seek a writ of mandamus in federal court compelling the agency to complete the section 204 investigation. *See Inouye Statement* at 4114. Indeed, AT&T filed just such a petition in connection with this tariff investigation. *In re AT&T Corp.,* No. 04-1032 (D.C. Cir., filed Jan. 26, 2004). A mandamus remedy -- a court directive to compel agency action -- is flatly at odds with commenters' claims that the Commission's violation of the section 204(a)(2)(B) deadline divests the Commission of its authority to act under section 204(a)(1).

[100] *BellSouth Comments* at 10, *Verizon Comments* at 3, 8.

FCC Form 492A.[101] The new price cap form was a modified version of FCC Form 492, used by rate-of-return carriers. In adopting the revised form the Commission stated it was seeking "a simplified and more relevant set of information," but was silent on the issue of add-back and rate of return calculations.[102] In addition to the caption of the form, the changes included the removal of report items 7 ("Net Return (incl. effect of FCC Ordered Refund) (3+6)") and 8 ("Rate of Return (incl. effect of FCC Ordered Refund) (7/4) Annualized") that appeared on Form 492, and the addition of a new report item called the "Sharing/Low End Adjustment Amount."

26. Commenters say these changes removed line item entries for reporting add-back adjustments, and consequently indicate that an add-back adjustment was no longer required in calculating and reporting rates of return. In order to adopt rules or change its rules, however, the Commission must do more than merely alter a reporting form. Under basic principles of reasoned decision making, the Commission must state that it is adopting a rule and explain the reasons why.[103] Here, however, the expressed purpose for changing the form was merely to simplify reporting.

27. When add-back was explicitly adopted prospectively by the *Add-Back Order* in 1995, the Commission modified the Commission's rules to reflect the decision and directed the Common Carrier Bureau to revise Form 492A to the extent necessary to reflect the add-back requirement more clearly.[104] The Bureau did not revise the form, likely because no changes to the form were necessary to implement the *Add-Back Order*. Rather, both Form 492 and Form 492A allowed price cap LECs to apply add-back and accurately report earnings and rates of return.

F. 1994 Investigation

28. In the public notice seeking to refresh the record in this proceeding, the Bureau explicitly invited parties to "present any legal argument or factual circumstance that would lead us to conclude that the decision reached with respect to appropriate treatment of sharing and low-end adjustments for the 1993 access tariffs should not control our treatment of sharing and low-end adjustments for the 1994 access tariffs."[105] None of the parties presented any reasons to persuade us to treat the two sets of tariffs differently. Therefore, based upon the administrative record before us, we conclude that the 1994 access tariffs of price cap LECs that did not apply add-back are unjust and unreasonable.

G. Required Filings

29. We order price cap LECs that implemented a sharing or lower formula adjustment and failed to apply add-back in their 1993 and 1994 access tariff filings to: (a) recalculate their 1992 and 1993 earnings and rates of return making such an adjustment; (b) determine the appropriate sharing or lower formula adjustment to their PCIs for the subsequent tariff year; (c) compute the amount of any resulting access rate decrease; and (d) submit a plan for refunding the amounts owed to customers plus interest as a result of any such rate decrease. After reviewing the recalculations and refund plans submitted in response to this order, and replies received on these recalculations and refund plans, we will, as

[101] 58 Fed. Reg. 1799 (April 2, 1993) (notice announcing approval of Form 492A).

[102] 1993 WL 755602 (F.C.C.) (Jan. 12, 1993) (notice announcing submission of proposed Form 492A to OMB for review and approval).

[103] *See* 5 U.S.C. § 706; *see also*, *Motor Vehicle Mfrs. Ass'n v. State Farm Mutual Automobile Ins. Co.,* 463 U.S. 29, 41-44 (1983).

[104] *Add-Back Order,* 10 FCC Rcd at 5666, para. 56. The *Add-Back Order* amended then section 61.3 (e) of the Commission's rules to clarify that "[B]ase year or base period earnings shall not include amounts associated with exogenous adjustments to the PCI for the sharing or lower formula adjustment mechanisms." *Id.* at 5667, App. B.

[105] *Add-Back Notice*, 18 FCC Rcd at 6487-88.

appropriate, approve, disapprove, or order modification of the filed recalculations and refund plans.

30. We also note that Verizon and Qwest argue that the rates subject to this investigation were below the rates that applicable PCIs would have allowed them to file and, therefore, they have "headroom" which precludes the Commission from ordering refunds.[106] While this claim may have merit, we cannot make a determination that any applicable refunds are offset by headroom until we review the recalculations and replies to the recalculations submitted in response to this order. Therefore, any price cap LEC claiming that headroom offsets any refund obligation should provide detailed calculations demonstrating this fact in response to this order.

IV. FILING PROCEDURES

31. Recalculations and, if applicable, refund plans in response to this order are due **August 30, 2004.** Replies to the recalculations and any applicable, refund plans are due **September 13, 2004.** When making these filings please reference CC Docket Nos. 93-193 and 94-65. An original and four copies of all filings should be addressed to Marlene H. Dortch, Secretary, Federal Communications Commission, 445 12th Street, SW, Room TW-B204, Washington, DC 20554. A courtesy copy should be addressed to Chief, Pricing Policy Division, Wireline Competition Bureau, 445 12th Street, S.W., Room 5-A225, Washington, DC 20554, and e-mailed to julie.saulnier@fcc.gov. A courtesy copy should also be addressed to Best Copy and Printing, Portals II, 445 12th Street, S.W., Room CY-B402, Washington, DC 20554, telephone 1-800-378-3160, or sent via e-mail to www.bcpiweb.com. Parties also are strongly encouraged to submit their filings via the Internet through the Electronic Comment Filing System at http://www.fcc.gov/cgb/ecfs/. Generally, only one copy of an electronic submission must be filed. In completing the transmittal screen, parties should include their full name, Postal Service mailing address, and the applicable docket number, which in this instance is CC Docket Nos. 93-193 and 94-65. Parties may also submit an electronic comment via Internet e-mail. To get filing instructions for e-mail comments, parties should send an e-mail to ecfs@fcc.gov, and should include the following words in the body of the message: "get form." A sample form and directions will be sent in reply.

32. Interested parties who wish to file via hand-delivery are also notified that the Commission will only receive such deliveries weekdays from 8:00 a.m. to 7:00 p.m., via its contractor, Natek, Inc., located at 236 Massachusetts Avenue, NE, Suite 110, Washington, DC 20002. **The Commission no longer accepts these filings at 9300 East Hampton Drive, Capitol Heights, MD 20743.** Please note that all hand deliveries must be held together with rubber bands or fasteners, and envelopes must be disposed of before entering the building. In addition, this is a reminder that the Commission no longer accepts hand-delivered or messenger-delivered filings at its headquarters at 445 12th Street, SW, Washington, DC 20554. Messenger-delivered documents (*e.g.*, FedEx), including documents sent by overnight mail (other than United States Postal Service (USPS) Express and Priority Mail), must be addressed to 9300 East Hampton Drive, Capitol Heights, MD 20743. This location is open weekdays from 8:00 a.m. to 5:30 p.m. USPS First-Class, Express, and Priority Mail should be addressed to the Commission's headquarters at 445 12th Street, SW, Washington, DC 20554. The following chart summarizes this information:

[106] *1993 Annual Access Tariffs*, CC Docket No. 93-193; *1994 Annual Access Tariffs,* CC Docket No. 94-65, Letter from Joseph Mulieri, Vice President, Federal Regulatory Advocacy, Verizon to Marlene H. Dortch, Secretary, Federal Communications Commission dated March 1, 2004 at 8-12; Letter from John W. Kure, Executive Director – Federal Regulatory, Qwest to Marlene H. Dortch, Secretary, Federal Communications Commission dated March 29, 2004 at 2.

TYPE OF DELIVERY	PROPER DELIVERY ADDRESS
Hand-delivered paper filings	236 Massachusetts Avenue, NE, Suite 110, Washington, DC 20002 (Weekdays - 8:00 a.m. to 7:00 p.m.)
Messenger-delivered documents (*e.g.*, FedEx), including documents sent by overnight mail (this type excludes USPS Express and Priority Mail)	9300 East Hampton Drive, Capitol Heights, MD 20743 (Weekdays - 8:00 a.m. to 5:30 p.m.)
USPS First-Class, Express, and Priority Mail	445 12th Street, SW Washington, DC 20554

V. ORDERING CLAUSES

33. Accordingly, IT IS ORDERED that, pursuant to sections 4(i), 4(j), 201(b), 204(a), and 403 of the Communications Act of 1934, as amended, 47 U.S.C. §§ 154(i), 154(j), 201(b), 204(a), and 403, the 1993 and 1994 annual access tariffs of price cap local exchange carriers failing to make the add-back adjustment ARE UNLAWFUL.

34. IT IS FURTHER ORDERED that the price cap LECs that failed to apply an add-back adjustment in their 1993 and 1994 access tariff filings SHALL RECALCULATE their 1992 and 1993 earnings making such an adjustment in compliance with this order, DETERMINE any applicable sharing or lower formula adjustment to their PCIs for the subsequent tariff year, COMPUTE the amount of any resulting access rate decrease, and SUBMIT PLANS for implementing any resulting refunds with interest to their access customers, no later than **August 30, 2004.**

FEDERAL COMMUNICATIONS COMMISSION

Marlene H. Dortch
Secretary

APPENDIX

Add-Back Example

The following example[1] illustrates the effects of an add-back adjustment under the price cap rules and shows that the adjustment is a necessary component of the sharing mechanism. The example examines the effects of different regulatory requirements on a company that in the base year has revenues of $2425, expenses of $1000, and a rate base of $10,000. Therefore, the company's base year return (*i.e.*, revenues minus expenses) is $1425 ($2425 minus $1000). The company's rate of return (ROR) (*i.e.*, return divided by rate base) is 14.25 percent ($1425 divided by $10,000).

Assume first that a company under rate-of-return regulation is required to refund earnings above a 13.25 percent rate of return, measured on a calendar year basis and that the company earns 14.25 percent in year 1. Assume further that the company makes its refunds through a refund check that is issued on the last day of year 1 rather than by reducing its rates in the coming year. The following chart shows the effects of the refund requirement on the company in years 1 through 4, assuming constant revenues, expenses and rate base.

	Year 1	**Year 2**	**Year 3**	**Year 4**
Revenues	2,425	2,425	2,425	2,425
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	14.25	14.25	14.25	14.25
Refund	100	100	100	100
ROR (net of regulation)	13.25	13.25	13.25	13.25

As this example shows, because the company refunds the money owed at the end of the year in which the liability is incurred, no adjustment to its revenues is necessary in the following year.

Assume now that the same company is instead subject to a sharing obligation with an add-back requirement. Assume further that the company is required to share 50 percent of its earnings above a 12.25 percent rate of return. The following chart shows the effect of the add-back requirement on the company in years 1 through 4, again assuming constant revenues, expenses and rate base.

[1] This example is taken from the *Add Back Order,* 10 FCC Rcd at 5659-5661, paras. 18-28.

Add-Back Adjustment

	Year 1	Year 2	Year 3	Year 4
Revenues	2,425	2,325	2,325	2,325
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
Add-Back	0	100	100	100
ROR with Add-Back	14.25	14.25	14.25	14.25
Sharing (to be deducted in the next year)	100	100	100	100
ROR (net of regulation)	13.25	13.25	13.25	13.25

By including an add-back adjustment to its earnings in Year 2 and thereafter, the company has the same rate of return and returns the same amount of money to ratepayers as the rate-of-return regulated company that makes its refund by a check. The add-back adjustment measures the company's performance in year 2 and each subsequent year after eliminating the effect of its performance in the prior year from the calculation of the current year's earnings.

Contrast the foregoing results with those that occur if the same company is subject to a sharing obligation, but without an add-back requirement.

No Add-Back Adjustment

	Year 1	Year 2	Year 3	Year 4
Revenues	2,425	2,325	2,375	2,350
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
Sharing (to be returned in next year)	100	50	75	62.50
ROR	14.25	13.25	13.75	13.50

Under this scenario, the company shares fewer revenues than it would under the rate-of-return or add-back scenarios and earns a different rate of return each year, even though its financial performance and underlying costs did not change.

The foregoing examples show that adding back an amount equal to the sharing adjustment ensures that the earnings thresholds applied to determine price cap LECs' sharing obligations achieve the intended benefits of the sharing mechanism. In the example presented above, the add-back requirement ensures that a price cap carrier incurs the same sharing obligation ($100) in year 2 as a carrier that paid a refund

on the last day of the year in which the obligation was incurred. Without an add-back requirement, the price cap carrier would share a lower amount ($50) of its earnings from year 2, because the carrier would reduce its earnings in year 2 by the amount of the sharing obligation incurred in the prior year. That result would permit LECs to avoid or reduce their sharing obligations in year 2 if their unadjusted rate of return exceeded the sharing benchmarks established by the price cap rules.

A sharing adjustment under price caps operated very much like a refund under rate-of-return regulation in that the obligation arose because of the previous year's high earnings. Further, both the sharing adjustment and the refund occurred in the year after that in which the high earnings were realized.[2] In both cases, ignoring the effects of a sharing adjustment would make a LEC's earnings, and therefore its productivity, appear to be lower than it actually was during the year in which the sharing amount was flowed through to ratepayers.

A comparison of three scenarios involving a low-end adjustment similarly shows that an add-back adjustment is necessary to achieve the intended benefits of the low-end adjustment. These scenarios assume a company that has revenues of $1925, expenses of $1000 and a rate base of $10,000.

Assume first that the company receives its low-end adjustment through a check issued to it on the last day of the year in which the low earnings occur.

	Year 1	**Year 2**	**Year 3**	**Year 4**
Revenues	1,925	1,925	1,925	1,925
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	9.25	9.25	9.25	9.25
Low-End Adj.	100	100	100	100
ROR with Adj.	10.25	10.25	10.25	1025

Now assume that the same company is instead subject to a low-end adjustment mechanism with an add-back requirement.

[2] The rate-of-return regulation example here assumes that the sharing occurs at the end of the year in which the excess earnings occurred. In actual practice, rate-of-return regulation requires that excess earnings be returned through sharing in the subsequent year and that add-back be applied to produce a result equivalent to writing a refund check at the end of the year in which the excess earnings occurred.

Add-Back Adjustment

	Year 1	Year 2	Year 3	Year 4
Revenues	1,925	2,025	2,025	2,025
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR (before add-back)	9.25	10.25	10.25	10.25
Add-Back	0	-100	-100	-100
Low-End Adj.	100	100	100	100
ROR with Add-Back	9.25	9.25	9.25	9.25

As in the sharing example, the company that makes an add-back adjustment to its revenues in the second year to account for the low-end adjustment incurred in the first year has the same rate of return and receives the same amount of money as the company under rate-of-return regulation that receives its low-end adjustment through a check issued at the end of year 1.

Contrast those results with the effect of a low-end adjustment mechanism without an add-back adjustment on the same company.

No Add-Back Adjustment

	Year 1	Year 2	Year 3	Year 4
Revenues	1,925	2,025	1,925	2,025
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
Low-End Adj. (to be regained in next year)	100	0	100	0
ROR	9.25	10.25	9.25	10.25

Under this approach, the company receives less revenues for the low-end adjustment than it would under the two other approaches illustrated above and would report a different rate of return each year, even though its financial performance and underlying cost did not change.

Without an add-back adjustment, LECs that make low-end adjustments because of prior years' low earnings would be entitled to smaller adjustments if their current year's earnings fell below the low end of the range. As our example shows, ignoring the amount ($100) paid to the carrier as a low-end adjustment for the prior year would inflate the carrier's earnings in year 2. Over time, effective earnings could fall below the benchmark levels that the Commission established as an integral part of its initial price cap regulatory regime. For example, the LECs' unadjusted 1993 rates of return used to compute 1994 sharing and lower-end adjustments would on average be 0.2 percent higher at the upper end, and 0.5 percent lower at the low end than if adjusted. The add-back adjustment, however, corrects these deviations and ensures that the LECs' earnings fall within the range the Commission selected in the *LEC Price Cap Order*.